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**BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554**

In the Matter of

1998 Biennial Regulatory Review --
Review of Depreciation Requirements
for Incumbent Local Exchange Carriers

Forbearance From Depreciation Regulation
of Price Cap Local Exchange Carriers

CC Docket No. 98-137

ASD 98-91

**REPLY COMMENTS
of the
GENERAL SERVICES ADMINISTRATION**

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Summary

In these reply comments GSA refutes the contention of the incumbent LECs that price cap regulation has made Commission regulation of depreciation unnecessary. GSA agrees with the Commission's analysis that depreciation regulation remains critical to the preservation of just and reasonable rates.

The LEC suggestion that the plant lives used for financial book purposes would provide an acceptable alternative to Commission prescribed lives is in error. As the Commission has found, the conservatism of financial book lives is effective in protecting the interests of investors, but not the interests of ratepayers. As GSA explains, the economic lives prescribed by the Commission are forward-looking and appropriate for regulatory use.

GSA also opposes the LEC proposal that the expensing of net salvage be made optional. This proposal would severely degrade the effectiveness of the Uniform System of Accounts. Instead, GSA recommends that the Commission defer consideration of any change in the treatment of net salvage until a final standard has been adopted by the Financial Accounting Standards Board.

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GENERAL SERVICES ADMINISTRATION

The General Services Administration ("GSA") submits these Reply Comments on behalf of the customer interests of all Federal Executive Agencies ("FEAs") in response to the Commission's Notice of Proposed Rulemaking ("NPRM") released October 14, 1998. The NPRM invited comments on Commission proposals to further streamline the depreciation represcription process. GSA will also reply to comments on the Petition filed by the United States Telephone Association ("USTA") requesting that the Commission forbear from regulating the depreciation and amortization practices of local exchange carriers ("LECs") subject to price cap regulation.¹

I. Introduction

On November 23, 1998, GSA filed comments in this proceeding generally supporting the Commission's proposals and opposing USTA's Petition. GSA has reviewed

¹ Public Notices released September 29 and October 16, 1998.

the comments of the following other parties:

- USTA;
- All five Regional Bell Holding Companies ("RBHCs");
- Two other incumbent Local Exchange Carriers ("LECs");
- Two Interexchange Carriers ("IXCs");
- Sprint, which is both a LEC and an IXC;
- Two state commissions; and
- The Ad Hoc Telecommunications Users Committee ("Ad Hoc").

Since GSA is in general agreement with the comments submitted by the IXCs, the state commissions and Ad Hoc, these reply comments will focus principally on the comments of the LECs. These LEC comments echo the arguments presented in USTA's Petition for Forbearance of September 21, 1998, that depreciation regulation is not necessary to ensure the reasonableness of the rates of LECs subject to price cap regulation, that depreciation regulation is not needed to protect consumers, and that there is no public interest justification for maintaining this burdensome regulatory requirement.² Additionally, most of the LECs opposed the Commission's proposal to mandate the expensing of net salvage and found the single adjustment in the approved parameter ranges inadequate. In these reply comments, GSA will address the principal arguments presented by the LECs in support of these positions.

² Petition at i and ii.

II. The LECs Have Not Shown That Depreciation Regulation Is Unnecessary

The principal thrust of the LECs' comments is that price cap regulation has rendered regulation of depreciation unnecessary. The Commission correctly disagrees. In paragraph 6 of its NPRM, the Commission lists six situations in which depreciation remains a significant regulatory factor even under the current price cap rules:

- (1) a calculation of a low-end adjustment;
- (2) a recalculation of the productivity factor;
- (3) an exogenous cost determination;
- (4) a calculation of the Base Common Line charges;
- (5) the cost support a carrier would have to provide if it proposed an Actual Price Index higher than its Price Cap Index; and
- (6) prices or federal support payments for universal service.

GSA has suggested an additional situation, in which a carrier seeks to offer a new interstate access service for which no price cap has been established.³

A. Depreciation Rates Affect Low-End Adjustments.

The Lower Formula Adjustment Mechanism ("LFAM") creates an undeniable link between costs and interstate rates. When a carrier's earned rate of return falls below a Commission-determined threshold, it may apply for an upward adjustment in its price caps.⁴

³ GSA Comments at 3.

⁴ 47 C.F.R. § 61.45 (d)(l)(vii).

The NPRM requests comments on whether the LECs should be permitted to escape regulation of depreciation on the condition that they renounce the remedy of the low-end adjustment.⁵ With the sole exception of the author of this proposal, BellSouth, none of the LECs endorses this recommendation. Bell Atlantic correctly notes that the Commission offers a "Hobsian Choice" which, if taken, could result in rates that are unlawful.⁶

The LECs nonetheless dismiss the low-end adjustment as a basis for continued regulation of depreciation. They argue that this remedy is rarely used, and if it is used, the Commission can review the reasonableness of the applicant's depreciation rates at the time of its filing.⁷

The argument that the low-end adjustment has been rarely used is irrelevant. In GSA's opinion, its comparatively limited use results from two reasons. The first is the inadequacy of the Commission's prescribed X-Factor productivity offsets, which have allowed the LECs to enjoy extraordinary and increasing rates of return on their interstate services.⁸ An X-Factor that truly reflects the productivity experience of the industry, plus a consumer dividend, would result in more frequent applications for a low-end adjustment.

The second reason accounting for the comparative rarity of low-end adjustment applications is the Commission's continued regulation of depreciation. Without this restraint on the LECs' discretion to set depreciation rates, some -- possibly many -- carriers

⁵ NPRM at para. 8, 18.

⁶ Bell Atlantic Comments at ftn. 4.

⁷ SBC Comments at 8; Bell Atlantic Comments at 6; Ameritech Comments at 7; U S WEST Comments at 7.

⁸ See Access Charge Reform, CC Docket No. 96-262, GSA Comments, October 26, 1998, at 3-7.

might have succumbed to the temptation to increase their depreciation expenses to create the appearance of a rate of return low enough to justify low-end price cap adjustments.

It is totally infeasible to expect the Commission to be able to evaluate each applicant carrier's depreciation rates on a case-by-case basis. Having given up all oversight of depreciation, the Commission would have little or no basis on which to make such an evaluation. Even assuming that the Commission could somehow determine that an applicant carrier had overstated its depreciation expense, the implementation of this determination would be extremely difficult. The Commission would have to restate the entire record of depreciation expense and accruals under new, hypothetical depreciation rates. The task would be time-consuming, burdensome on all parties, and most of all, contentious.

B. Depreciation Changes Are Relevant For Productivity Measurement.

Depreciation is an important input into the models used by the Commission to measure the productivity of the telephone industry. To the extent that depreciation is misstated, productivity is also incorrect. For this reason, it is appropriate and necessary for the Commission to maintain continued oversight of depreciation rates.

Both USTA and SBC argue that the effect of a depreciation rate change on the calculation of the X factor measurement of productivity is self-canceling.⁹ If so, then there may be something wrong with the formula. The Commission has assumed that an increase in depreciation reflects an increase in the rate of capital consumption, which increases the absolute level of inputs. This increase should not affect the rate of output,

⁹ SBC Comments at 8-10; USTA, Attached Affidavit of Frank M. Gollop.

which is service to the public. That the Commission has used telephone-specific deflators to convert output to constant dollars in a manner that offsets the increase in inputs would appear to be a flaw in the output measurement.

If the carriers are allowed to set their own depreciation rates, the Commission can be sure that the LEC industry will seek to correct this flaw. The carriers will argue (correctly, from a conceptual standpoint) that depreciation rate increases do not reflect inflation, but rather an increase in the rate of capital consumption. Therefore, they should be incorporated into the measurement of inputs, but not the price adjustments for outputs. Under that prescription, depreciation rate increases would translate into lower productivity and higher price caps.

C. Depreciation May Affect Exogenous Factor Adjustments.

The LECs argue that because depreciation has been designated as an endogenous factor, it is unlikely to have any influence on exogenous factor adjustments.¹⁰ The designation of depreciation as endogenous, however, does not mean that depreciation will never affect exogenous changes.

BellSouth has provided an example of just such a exogenous change. Attached to BellSouth's comments is a discussion of an Exposure Draft of the Financial Accounting Standards Board ("FASB") dealing with accounting for obligations associated with the retirement of long-lived assets. Among the changes this document considers is the explicit recognition of obligations to incur costs upon the retirement of long-lived assets. The

¹⁰ BellSouth Comments at 18; SBC Comments at 10; Ameritech Comments at 8; U S WEST Comments at 8; USTA, Affidavit of Taylor/Benarjee at 14, 15.

liability associated with these obligations would be determined using cash flow techniques. If those techniques involve discounting, as would appear to be the case, then the calculation of annual net salvage allowances under the new FASB standard would differ considerably from that routinely used for purposes of Commission regulation. The conversion from one form of salvage accounting to the other would be an exogenous change deeply involved with depreciation.

For the Commission to make an exogenous adjustment in the price cap formula to recognize this accounting change, it would have to determine how much of the affected accounts' depreciation relates to final net salvage, recompute the net salvage allowances using the cash flow technique, and adjust price caps for the difference between these two allowances. Without any explicit understanding of the basis for the current net salvage allowances, the Commission would be unable to make, or even monitor, these calculations, and instead would have to rely on the word of the carriers. This would not be a reassuring regulatory procedure.

D. Depreciation Affects the Base Factor Portion of Common Line Charges

None of the LECs argue that depreciation does not affect the residual common line revenue that is recovered in the Carrier Common Line Charge ("CCLC"). They generally acknowledge that this charge is designed to recover the residual requirement that is in the common line basket after the ceilings on the End User Common Line ("EUCL") and Presubscribed Interexchange Carrier Charge ("PICC") have been reached. Since this is a revenue requirement calculation, it is affected by depreciation. They argue, however, that the Commission is phasing out the CCLC and that the overall amount of common line

revenue recovery is constrained by price caps.¹¹

The fact remains that a revenue requirement calculation is used to establish the residual revenue to be recovered by the CCLC, and depreciation is part of that calculation. The carriers cannot be freed to manipulate the makeup of the common line charges because those charges are often imposed on competitors. When the LEC is a RBOC, the competitive relationship is indirect: the IXC paying the charge may also be an intra-LATA toll service provider or it may be entering the local exchange market as a Competitive Local Exchange Carrier ("CLEC"). When the LEC is a non-RBOC, the competition may be direct. Both carriers are offering interstate toll service, but one is an incumbent LEC with the Commission-endowed authorization to levy interstate access charges on the other. The makeup of the common line revenue recovery is thus not competitively neutral.

Possibly when the full amount of common line revenue is recovered from the EUCL and PICC charges, this justification for depreciation regulation will disappear. For the present, however, it has not.

E. Depreciation Is Relevant for Above-Cap Filings

The LECs' arguments relating to filings for rates that exceed price caps are virtually identical to those relating to the low-end adjustment: such filings are rare and if they are made, the Commission has the power to investigate them, including the reasonableness of depreciation expense.¹²

¹¹ BellSouth Comments at 19, 20; USTA, Affidavit of Taylor/Benarjee at 16; U S WEST Comments at 8; Ameritech Comments at 8; SBC Comments at 11.

¹² BellSouth Comments at 20; USTA, Affidavit of Taylor/Banarjee at 16, 17; Bell Atlantic Comments at 7; SBC Comments at 11; U S WEST Comments at 8,9.

The response is the same as well. These filings are rare in part because the Commission does not allow the carriers to set their own depreciation rates in a manner that would appear to justify above-cap price adjustments. If the Commission were to deregulate depreciation, it would have no basis upon which to determine the reasonableness of the depreciation expense included in the cost justification for the above cap rates.

F. Depreciation Is Used to Calculate Interstate Universal Service Support

In para. 6 of the NPRM, the Commission notes that it has required incumbent LECs to use depreciation factors within the FCC authorized ranges when calculating forward-looking economic costs for purposes of supporting universal service through high cost area subsidies. The Commission observes that some state commissions have also used the parameter ranges in setting intrastate support mechanisms.

The LECs do not challenge these observations, nor do they question the need for life and salvage parameters in the costing models to be used for universal support measurement. Instead, they attack the Commission's depreciation parameter ranges. Several of the LECs assert that the currently approved ranges are based on backward-looking views of historical retirement experience and therefore fail to acknowledge that economic lives in the future will be much different (i.e. shorter) than in the past.¹³

The error of the LECs' argument is that the FCC parameters are forward-looking and economic. Over a decade ago the Commission directed its staff to put less emphasis

¹³ See, e.g., Ameritech Comments at 5-6; Bell Atlantic Comments at 9-10; BellSouth Comments at 6-7.

on historic data in estimating productive lives, and to pay "closer attention to company plans, technological developments and other future-oriented analyses."¹⁴ More recently, the Commission reaffirmed its forward-looking orientation in connection with its simplification of its depreciation represcription practices. It stated that the approved depreciation parameter ranges were based upon "statistical studies of the most recently prescribed factors. These statistical studies required detailed analysis of each carrier's most recent retirement patterns, the carriers' plans, and the current technological developments and trends."¹⁵ As such, these parameters are designed to allow forward-looking capital recovery.

But even if the LECs were correct that the prescribed parameter ranges are inappropriate as forward-looking estimates, this conclusion would hardly justify abandonment of Commission oversight over depreciation. The Commission has a public interest responsibility to ensure that carriers seeking universal service support are not inflating their costs so as to inflate their support payments. Oversight of costs necessarily involves oversight of depreciation.

¹⁴ Report on Telephone Industry Depreciation, Tax and Capital/Expense Policy, Accounting and Audits Division, Federal Communications Commission, April 15, 1987 ("ADD Report").

¹⁵ FCC, Simplification of the Depreciation Prescription Process, CC Docket No. 92-296 ("Prescription Simplification" proceeding) Third Report and Order, FCC 95-181, released May 4, 1995, p. 6.

G. Depreciation Is Required for New Interstate Services.

Finally, GSA notes that the Commission needs to establish depreciation parameters by which to judge the acceptability of rates for new access services that have not previously been offered. A new service, of course, has no Actual Price Index, since it has no history of prices. The only basis for establishing a new price is cost, of which depreciation is an important component.

GSA cannot predict whether new services will be offered or what those services will be. It notes, however, that new switching technologies, such as Asynchronous Transfer Mode ("ATM") allow signals of varying bandwidths to be transmitted through the public switched network. This suggests the possibility of a number of new variable bandwidth access offerings in addition to Plain Old Telephone Service. Initially, at least, the prices of these offerings will have to be based on costs, including depreciation costs.

III. The Carriers' Alternatives to Depreciation Regulation Are Unacceptable

A. GAAP Is Not a Suitable Substitute For Commission Regulation.

Several LECs suggest that Generally Accepted Accounting Principles ("GAAP") provide an adequate constraint on the setting of depreciation rates.¹⁶ GAAP is used to establish the depreciation rates that are used for financial accounting, and such rates are subject to the oversight of the Securities and Exchange Commission ("SEC"). Ever since the LECs abandoned regulatory accounting under FASB Standard No. 71 in the mid-1980s, their financial depreciation rates have differed from their regulatory rates, the former

¹⁶ SBC Comments at 27, 28; BellSouth Comments at 4,5; GTE Comments at 12-15.

having been established pursuant to GAAP, the latter pursuant to the Commission and the state commissions.

The Commission has already addressed this issue. In its 1993 Depreciation Simplification Order, the Commission found that the lives used for financial accounting purposes are governed by the GAAP principle of "conservatism." GAAP is investor-focused and may not always serve the interest of ratepayers. The Commission stated:

"One of the primary purposes of GAAP is to ensure that a company does not present a misleading picture of its financial condition and operating results by, for example, overstating its asset values or overstating its earnings, which would mislead current and potential investors. GAAP is guided by the conservatism principle which holds, for example, that, when alternative expense amounts are acceptable, the alternative having the least favorable effect on net income should be used. Although conservatism is effective in protecting the interest of investors, it may not always serve the interest of ratepayers. Conservatism could be used under GAAP, for example, to justify additional (but, perhaps not "reasonable") depreciation expense by a LEC...."¹⁷

GSA submits that nothing has changed that should alter the Commission's observations made in 1993. GAAP lives are not suitable for regulatory purposes.

¹⁷ Prescription Simplification, Report and Order, FCC 93-452, released October 20, 1993, para. 49.

B. Surrogate Depreciation Factors from Unregulated Competitors Are Inappropriate.

GTE proposes that if the Commission declines to use GAAP financial reporting depreciation, it should use surrogate depreciation factors for comparable equipment by large, unregulated competitors to the LECs. GTE suggests that the LECs' switching and transmission equipment depreciation rates be based on an average of the lives used by top interexchange carriers, and the LECs' loop plant depreciation could reflect an average of the top cable TV operators.¹⁸

This proposal is without merit. To begin with, the depreciation lives used by the surrogate entities are themselves GAAP lives and therefore suffer from the same infirmities the Commission identified with respect to GAAP depreciation: it is designed to protect shareholders rather than ratepayers. Even without this flaw, it would be wholly inappropriate to apply the plant lives of IXC's and cable companies, which operate very different businesses, to the LECs' plant. An AT&T toll switch may be similar mechanically to an LEC's end office local switch, but relevant business dynamics -- competition, growth, traffic variations, feature requirements -- are totally different. Cable TV plant is not even similar to telephone plant, since it consists heavily of coaxial cable no longer used for telephone distribution. More importantly, there are great differences between the technological, competitive, institutional and structural characteristics of the cable TV industry and the LEC industry.

¹⁸GTE Comments at 15, 16.

IV. The Commission Should Defer Changes In Net Salvage Treatment

In its initial Comments, GSA supported the Commission's proposal to abandon the recovery of net salvage through depreciation rates and treat salvage and cost of removal as expenses on a going-forward basis.¹⁹ Most of the LECs opposed this proposal as a mandatory change, but supported it as an option.²⁰

GSA does not support the optional expensing of salvage. A Uniform System of Accounts should be just that: uniform. To allow carriers the alternative of capitalization or expensing net salvage would degrade the quality of the carriers' reports, create inconsistent measurements of costs and earnings, and increase the possibility of carriers "gaming" the regulatory system to their advantage and to the disadvantage of ratepayers.

More to the point, however, is the fact that the accounting profession's treatment of removal and dismantlement costs is undergoing evaluation and possible change. BellSouth attached a report from the Financial Accounting Standards Board ("FASB") staff that describes some of these changes, and Sprint indicates that another exposure draft is expected in the first quarter of 1999.²¹ Given the pendency of these changes, GSA recommends that the Commission defer consideration of any change in the treatment of net salvage until a final FASB standard has been adopted.

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¹⁹ GSA Comments at 7-9.

²⁰ See, e.g., Cincinnati Bell Telephone Comments at 8; GTE at 19.

²¹ Sprint Comments at 9.

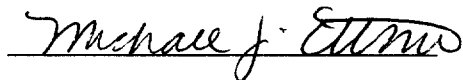
V. CONCLUSION

As a major user of telecommunications services, GSA urges the Commission to streamline the depreciation prescription process as recommended herein and reject USTA's Petition for forbearance.

Respectfully submitted,

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